STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: IOWA-AMERICAN WATER COMPANY	DOCKET NO. RPU-07-3

ORDER SETTING TEMPORARY RATES AND APPROVING CORPORATE UNDERTAKING

(Issued November 28, 2007)

On August 30, 2007, Iowa-American Water Company (Iowa-American) filed with the Utilities Board (Board) a proposal for a general rate increase in temporary and final water rates. Iowa-American proposed a temporary increase that would produce additional annual revenue for Iowa-American of approximately $4.1 million and a permanent increase that would produce additional annual revenue of approximately $6.124 million. On September 25, 2007, the Board docketed the proposed increases as Docket No. RPU-07-3.

On September 28, 2007, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed an objection to the request for temporary rates. Iowa-American filed a response to the objection on October 18, 2007.

Iowa Code § 476.6(10) (2007) controls the manner in which temporary rates are set. The statute gives the utility two options. First, the utility can place into effect temporary rates without Board review within ten days after the utility files its request, accompanied by a bond or corporate undertaking agreeing to make appropriate refunds if temporary rates exceed final rates. This first option has only been available since 2003. Second, the utility can ask that the Board determine temporary rates; the Board's decision must be made within 90 days of the utility's request for temporary rates. This is the traditional method of setting temporary rates that has been available since the inception of Iowa Code chapter 476. Iowa-American has chosen this second option, asking the Board to set temporary rates. With respect to the second option, § 476.6(10) provides, in part:

> Upon the request of a public utility, the board shall, when required by this subsection, grant the public utility temporary authority to place in effect any or all of the suspended rates, charges, schedules or regulations by filing with the board a bond or other undertaking approved by the board conditioned upon the refund in a manner to be prescribed by the board of any amounts collected in excess of the amounts which would have been collected under rates, charges, schedules or regulations finally approved by the board. In determining that portion of the new or changed rates, charges, schedules or regulations to be placed in effect prior to a final decision, the board shall apply previously established regulatory principles and shall, at a minimum, permit rates and charges which will allow the utility the opportunity to earn a return on common stock equity equal to that which the board held reasonable and just in the most recent rate case involving the same utility or the same type of utility service, provided that if the most recent final decision of the board in an applicable rate case was rendered more than twelve months prior to the day of filing of the request for temporary rates, the board shall in addition consider financial market data that is filed or that is otherwise available to the board and shall adjust the rate of return on common stock equity that was approved in that decision upward or downward as necessary to reflect current conditions.

In Northwestern Bell v. Iowa State Commerce Commission, 359 N.W.2d 491, 496 (Iowa 1984), the Iowa Supreme Court interpreted this portion of the statute and stated, in part:

> [I]n the 1983 Code the Assembly telescoped the temporary and permanent rate steps into one procedure, evidently to end the prior problem of a utility's placing its new rates in effect in temporary form under bond and then having little motivation to press forward with the permanent rate aspect. The General Assembly has ended the ability of the utility itself to set the temporary rates in the usual situation; the commission sets them and proceeds to the permanent rates. If instead the utility could obtain judicial review of temporary rates and obtain its desired rates from the courts, as in this case, its motivation to seek permanent rates would be dulled and fulfillment of the legislative scheme would be hampered. To minimize the possibility of harm to the utilities, the legislature started time running from the original filing as to both temporary and permanent rates . . .
>
> While permanent rates may ultimately be set higher than the commission's temporary rates, by shortening the time for the commission's final decision to ten months and by streamlining the temporary and permanent rate procedure, the Assembly has demonstrated its desire to minimize utility hardship.

The Board, therefore, is directed to permit Iowa-American to collect rates which, at a minimum, allow the return on common equity equal to that which was held reasonable in the most recent rate case involving the same utility or same type of utility service, provided the Board's decision was rendered within 12 months prior to Iowa-American's request for temporary rates. In addition, the Board is directed to apply established regulatory principles when setting the return on common equity and when considering any proposed adjustments. Since the Legislature directs the Board to establish a temporary rate level by applying established regulatory principles rather than examining an evidentiary record, it is not appropriate for the Board to make detailed findings of fact on each individual issue.

Consumer Advocate's objection to Iowa-American's request for temporary rates and Iowa-American's replies to the objection narrowed the issues to be considered in setting temporary rates to two operating revenues issues, four operating expenses issues, and two cost of capital issues, including return on equity. In addition to the foregoing issues, the Board will address Iowa-American's request for approval of its corporate undertaking and rate design and class cost of service, which were not contested for temporary rates. The issues to be addressed are:

I. COST OF CAPITAL

A. Capital structure
B. Return on common equity

II. OPERATING REVENUES

A. Presently approved tariff rates
B. Unbilled revenues, and the elimination of additional billed days of water and other revenues

III. OPERATING EXPENSES

A. Pension expense
B. Chemical expense
C. Labor related and post test year management fees
D. Group insurance expense

IV. CLASS COST OF SERVICE

V. RATE DESIGN

IV. CORPORATE UNDERTAKING

I. COST OF CAPITAL

A. Capital structure

Both Iowa-American and Consumer Advocate, consistent with Board precedent, recognize the effect of double leverage in the capital structure. By recognizing double leverage, the weighted average cost of capital of Iowa-American's parent company, American Water Works Company (AWWC), is used as the cost of equity for the regulated subsidiary, Iowa-American. The parties agree on all components of this calculation except for the common equity balances at AWWC.

Consumer Advocate in its objection pointed out two discrepancies or errors in Iowa-American's initial calculations. Iowa-American corrected these discrepancies in its reply to Consumer Advocate's objection, which had the effect of reducing Iowa-American's proposed weighted average cost of capital for temporary rates from 8.65 percent to 8.59 percent. The Board will use for temporary rate purposes the corrected equity balance for AWWC provided by Iowa-American in its reply comments.

B. Return on common equity

Iowa-American proposed to use an 11.25 percent cost of equity for its parent, AWWC. This produces a proposed 8.59 percent cost of equity for Iowa-American after applying double leverage and using Iowa-American's revised proposed capital structure adopted by the Board for temporary rate purposes. Consumer Advocate proposed a 9.8 percent cost of equity for AWWC, which produces an 8.102 percent cost of equity for Iowa-American after applying double leverage and using the capital structure adopted by the Board.

Iowa Code § 476.6(13) (2007) requires that the Board review current financial information if a Board decision on the cost of equity for the same type of utility service was rendered more than 12 month's prior to the current filing. Iowa-American's most recent water rate case (Docket No. RPU-01-4) was settled and the Board does not look at settled rate cases for determining the return on common equity for temporary rates. Also, the settlement in this case was approved over 12 months ago. Therefore, it is necessary for the Board to consider current market data.

The Board has in recent years placed greater reliance on the risk premium method in determining return on equity. Under the Board's risk premium approach, 250 to 450 basis points are added to the current A-rated utility bond yield, which is 6.24 percent (Moody's Long-Term Corporate Bond Yields-September 2007), to produce a range of reasonable figures. The risk premium approach produces a cost of equity range of 8.74 percent to 10.74 percent for temporary rates.

Iowa-American urged the Board to look at four other equity models (discounted cash flow, risk premium, capital asset, and comparable earnings), which produce common equity ranges of 9.9 to 14.1 percent. Iowa-American adds 20 basis points to these ranges as a business risk adjustment to reflect Iowa-American's relatively small size. The three market-based models used by Iowa-American produce a range between 9.9 and 10.8 percent; typically the Board has not given significant weight to the comparable earnings model in setting return on equity and will therefore not consider the model for establishing return on common equity in temporary rates. In addition, any business risk adjustment must be considered in the full rate case and will not be reflected in the return on common equity for temporary rates.

In reviewing current market data and the ranges produced by the Board's risk premium analysis and the other market-based models, the Board will set the return on common equity for AWWC at 10.4 percent. This becomes, through application of double leverage and use of the capital structure adopted by the Board for temporary rate purposes, an allowed return on equity for Iowa-American of 8.303 percent.

II. OPERATING REVENUES

A. Presently approved tariff rates

Iowa-American proposed an adjustment to operating revenues for each of its two operating districts (Clinton and Quad Cities) that adjusts its books to pro forma bill analysis at present rates, increasing revenues for the Clinton district by $1,835 and the Quad Cities district by $1,166. Consumer Advocate objected to the adjustments because there were no rate changes during the 2006 test year.

The Board has previously allowed the use of a bill analysis for temporary rates in Iowa-American's last rate case (Docket No. RPU-01-4) because the bill analysis is the most current information available; if it is shown to be inaccurate, it can be corrected in final rates. The Board will allow the adjustments proposed by Iowa-American.

B. Unbilled revenues and the elimination of additional billed days of water and other revenues

The three adjustments for unbilled revenues, elimination of additional billed days of water, and other revenues are interrelated. All of Iowa-American's proposed revenue adjustments were developed using its 365-day billing analysis.

The first adjustment adjusted the per books test year to the bill analysis. Consumer Advocate argued that no changes in rates occurred during the test year so no adjustment is necessary.

The second adjustment deals with unbilled revenues. Iowa-American revised its adjustment in its reply to Consumer Advocate, agreeing with Consumer Advocate in concept but disagreeing with its calculation because Iowa-American closed its books early in December 2005.

The third adjustment consisted of two items to eliminate additional billed days of revenue. This was also due to the early closing of books.

Iowa-American's books closed early in 2005, resulting in an additional 22 days of test year revenue. Iowa-American attempted, through its bill analysis, to quantify that amount. Consumer Advocate contended the bill analysis adjustments were not based on established regulatory principles, but Consumer Advocate did not offer an alternative adjustment that recognized the additional 22 days of test year revenue.

Because the test year contained 22 additional days of revenue, adjustments should be made to reflect this known and measurable event. Iowa-American's proposed adjustments best address this issue because they recognize the additional days of revenue; Consumer Advocate's adjustments do not. There is no clearlyestablished regulatory principle here because in one case the Board used bill analysis (Docket No. RPU-01-4) and the other it did not (Docket No. RPU-90-10); in this case, the Board concludes an adjustment is appropriate for temporary rates.

II. III. OPERATING EXPENSES

A. Pension expense

In prior rate cases, Iowa-American said it reflected pension expense based on the contribution to the pension trust fund required by the Employee Retirement Income Security Act (ERISA). For temporary rates, Iowa-American proposed to continue using the ERISA requirement. Both Iowa-American and Consumer Advocate urge the Board to use Statement of Financial Accounting Standard (SFAS) 87 for final rates; the parties disagree, though, on amortization issues.

For temporary rates Consumer Advocate proposed an adjustment using SFAS 87 consistent with the adjustment ordered in final rates in a U S West Communications case, Docket No. RPU-93-9. This adjustment appears to be most consistent with established regulatory principles and will be adopted by the Board for temporary rates. Amortization issues regarding SFAS 87 will be explored at the hearing on final rates.

B. Chemical expense

Iowa-American proposed adjustments to chemical expense for the Clinton ($1,624) and Quad Cities ($175,903) districts. Iowa-American adjusted test year chemical usage using a three-year average. Consumer Advocate argued the adjustments were not known and measurable and used an arbitrary three-year average of chemical usage. As an alternative, if its initial proposal was rejected, Iowa-American suggested that new prices should be applied to test year usage.

Iowa-American's calculations show chemical expense using test year prices and a three-year average usage. However, Iowa-American cited no regulatory precedent for using a three-year average to adjust chemical expense. The use of a three-year average for temporary rates will be disallowed.

The Board will, however, allow test year usage to be adjusted using the new prices because this is a known and measurable change. Based on Iowa-American's filing, which contains inconsistencies pointed out by Consumer Advocate, the Board cannot calculate the exact amount of the adjustment. Because the Clinton adjustment is small, the Board will use the $1,624 proposed initially by Iowa-American. For Quad Cities, Iowa-American will be required to calculate the amount of the adjustment using current prices and test year usage and file the supporting documentation with its compliance tariffs.

C. Labor related and post test year management fee

Iowa-American proposed an adjustment to increase its labor and related expenses. The adjustment contained several components, with the two most significant being the number of employees and wage levels. Iowa-American also made an adjustment to management fees. Iowa-American in its reply to Consumer Advocate substituted current labor rates for future labor rates, which Iowa-American said it mistakenly used in its original temporary rate request.

Consumer Advocate objected to both adjustments because they were not known and measurable. Consumer Advocate pointed out that the adjustments included current vacancies that might not be filled and were not limited to current employment levels.

The Board has consistently allowed labor adjustments for temporary rates, but only when the adjustments reflect the total number of employees on the payroll, not vacancies that might not be filled in the future. Labor adjustments for positions that are not currently filled are not known and measurable. The Board will allow adjustments for labor related and post-test year management fees, but Iowa-American must recalculate the adjustments by eliminating vacant positions. In addition, Iowa-American should use only actual hours worked in the test year and wage rates it was contractually obligated to pay. Other known and measurable adjustments (benefits, etc.) will also need to be recalculated if they are impacted by the labor and management fee adjustments. Data used to make all these adjustments must be included as part of Iowa-American's compliance tariff filing.

D. Group insurance expense

Iowa-American proposed adjustments to group insurance expense for the Clinton ($68,006) and Quad-Cities ($80,530) districts, arguing that the adjustments are based on group insurance rates effective January 1, 2007, and contributions paid to an employee benefit association. Consumer Advocate contended the adjustments are not known and measurable and are speculative.

Iowa-American's proposed adjustments are based on rates effective January 1, 2007, and contributions paid to an employee benefit association. The adjustments are known and measurable and will be used to set temporary rates. However, the adjustments must be based on current employment levels that exclude vacancies that might be filled in the future. Iowa-American will be required to exclude from its proposed adjustments any amounts related to employee vacancies that have not been filled and must include with its compliance tariffs all data used to arrive at the final group insurance adjustments for temporary rate purposes.

IV. CLASS COST-OF-SERVICE

Although it is not a contested issue, the Board will briefly comment on class cost-of-service. Prior to filing its rate case, Iowa-American obtained a waiver of, among other things, the requirement that a rate case filing be accompanied by a class cost-of-service study. 199 IAC 26.5(5)"e"(9). In its waiver request, Iowa-American said it would propose across-the-board rate increases and not propose class-based rate changes; a class cost-of-service study would increase Iowa-American's rate case expense, which is ultimately paid by ratepayers, by about $50,000. Because there is no new class cost-of-service study and rate increases will be across-the-board, Iowa-American will maintain its current class allocation structure for each of its two operating districts. The temporary rate increase authorized by this order will be an across-the-board increase.

V. RATE DESIGN

Rate design for temporary rates is not contested by the parties, but the Board will comment on Iowa-American's temporary rate proposal, which consisted of two parts. First, Iowa-American's proposal addresses the difference in private fire protection rates between the Clinton and Quad Cities districts, which will continue to be narrowed. Iowa-American's temporary rate proposal for private fire protection rates reflects what Iowa-American proposes for final rates and will be used for temporary rates.

Second, Iowa-American noted that with its across-the-board rate proposal for allocating increases for general metered service, rate differences between the two districts are not addressed. Iowa-American said it would continue to evaluate rate consolidation for future rate filings.

While the Board will not address any rate equalization between districts in temporary rates, the Board does not believe these rate differences should be exacerbated in temporary rates, which would happen if Iowa-American's proposal for general metered service were adopted. Under Iowa-American's proposal, the percentage rate increase for the Clinton district would be larger than for the Quad Cities District. Therefore, the Board will modify Iowa-American's method by requiring Iowa-American to levelize the percentage increases for general metered service between its two districts, which will produce uniform across-the-board percentage increases for general metered service in the Clinton and Quad Cities districts.

VI. CORPORATE UNDERTAKING

Iowa-American filed a corporate undertaking with its temporary rate application. Iowa-American has agreed to refund, with interest, any temporary rates which are collected that exceed final rates ultimately approved by the Board. This corporate undertaking is sufficient to ensure payment of any required refund and will be approved.

VII. ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. Temporary rates based on this order shall become effective as of the date of this order, pursuant to Iowa Code § 476.6(13) (2007). On or before 20 days from the date of this order, Iowa-American Water Company shall file revised tariff sheets that produce an increase in annual jurisdictional revenue not to exceed $2,982,814 (with any adjustments for group insurance expense, chemical expense, labor related expense, and post-test year management expense required by this order). Attached to this order, and incorporated by reference, are attachments A through D, reflecting a total water company revenue requirement, rate base, weighted cost of capital, and income statement for temporary rates.

2. Iowa-American Water Company's corporate undertaking is approved.

3. At the same time that Iowa-American Water Company files revised tariff sheets consistent with this order, it shall file documentation regarding the group insurance expense adjustments, chemical expense adjustment, labor related adjustment, and post-test year management adjustment as detailed in the body of this order.

UTILITIES BOARD

/s/ John R. Norris

/s/ Krista K. Tanner

ATTEST:

/s/ Judi K. Cooper
Executive Secretary

Dated at Des Moines, Iowa, this 28th day of November, 2007.

Attachment A

Iowa-American Water Company
Revenue Requirement
Docket Number RPU-07-3
Temporary Rates

Line No.	Description	Quad Cities District Amount (A)	Clinton District Amount (B)	Total Iowa-American Amount (C)
1	Rate Base	$ 59,843,246	$ 10,313,420	$ 70,156,666
2	Rate of Return	8.303%	8.303%	8.303%
3	Allowed Return	$ 4,969,066	$ 856,372	$ 5,825,438
4	Adjusted Test Year Net Income	$ 3,530,204	$ 552,376	$ 4,082,580
5	Additional Income Required	$ 1,438,862	$ 303,996	$ 1,742,858
6		$ -	$ -	$ -
7	Income Tax Effect	$ 1,023,678	$ 216,278	$ 1,239,956
8	Revenue Deficiency/(Excess)	$ 2,462,540	$ 520,274	$ 2,982,814
9	Adjusted Test Year Revenue	$ 19,626,551	$ 3,843,937	$ 23,470,488
10	Revenue Requirement	$ 22,089,091	$ 4,364,211	$ 26,453,302
11	Percent Increase (Line 8 / 9)	12.55%	13.53%	

Attachment B

Iowa-American Water Company
Adjusted Rate Base
Docket Number RPU-07-3
Temporary Rates

Line No.	Description	Quad Cities District Amount (A)	Clinton District Amount (B)	Total Iowa-American Amount (C)
1	Utility Plant in Service	$ 101,401,096	$ 17,644,359	$ 119,045,455
2	Capital Leases (net of accum. amort.)	$ -	$ -	$ -
3	Accum. Depreciation	$ (27,603,861)	$ (5,486,077)	$ (33,089,938)
4	Net Utility Plant	$ 73,797,235	$ 12,158,282	$ 85,955,517
5	Accumulated Deferred ITC-pre 1971	$ (50,142)	$ (6,074)	$ (56,216)
6	Customer Advances for Construction	$ (4,615,149)	$ (240,274)	$ (4,855,423)
7	Contributions in Aid of Construction	$ (2,441,706)	$ (177,866)	$ (2,619,572)
8	Deferred Taxes-Liberalized Depr.	$ (8,365,587)	$ (1,551,694)	$ (9,917,281)
9	Customer Deposits	$ -	$ -	$ -
10	Allowance for Doubtful Accounts	$ (126,640)	$ (26,097)	$ (152,737)
11	Materials and Supplies	$ 148,216	$ 30,117	$ 178,333
12	Prepayments	$ 96,021	$ 17,398	$ 113,419
13	Cash Working Capital	$ 1,162,090	$ 109,628	$ 1,271,718
14	Total	$ 59,843,246	$ 10,313,420	$ 70,156,666

Attachment C

Iowa-American Water Company
Rate of Return
Docket Number RPU-07-3
Temporary Rates

Parent: American Water Works Company

Line No.	Description	Amount (A)	Ratio (B)	Cost Rate (C)	Weighted Cost (D)
1	Long-Term Debt	*		*	
2	Preferred Equity	*		*	
3	Common Equity	*		10.400%	
4	Total		100.000%		9.102%

Subsidiary: Iowa-American Water Company

Line No.	Description	Amount (A)	Ratio (B)	Cost Rate (C)	Weighted Cost (D)
1	Long-Term Debt	$33,418,259	52.821%	7.590%	4.009%
2	Preferred Equity	$0	0.000%	0.000%	0.411%
3	Common Equity	$29,848,823	47.179%	9.102%	4.294%
4	Total	$63,267,082	100.000%		8.303%

* Parent company, American Water Works, information granted confidentiality.

Attachment D

Iowa-American Water Company
Adjusted Income Statement
Docket Number RPU-07-3
Temporary Rates

Line No.	Description		Quad Cities District Amount (A)		Clinton District Amount (B)		Total Iowa-American Amount (C)
1	Operating Revenues	$	19,626,551	$	3,843,937	$	23,470,488
2	Oper. and Maint. Expense	$	10,791,585	$	2,215,000	$	13,006,585
3	Depreciation	$	2,429,900	$	570,227	$	3,000,127
4	Amort. of Limited Term Plant	$	11,112	$	-	$	11,112
5	Amort. of Post-in-Service AFUDC	$	13,659	$	2,815	$	16,474
6	Amort. of Reg. Asset-AFUDC	$	11,064	$	2,280	$	13,344
	Taxes other than Income Taxes						
7	Real and Personal Property	$	1,742,037	$	325,580	$	2,067,617
8	Utility Division Fees	$	15,669	$	3,047	$	18,716
9	Other General Taxes	$	5,064	$	1,044	$	6,108
10	Federal Unemployment	$	2,397	$	602	$	2,999
11	FICA	$	150,125	$	36,308	$	186,433
12	State Unemployment	$	5,458	$	2,240	$	7,698
	Income Taxes						
13	Fed Income - Current	$	456,824	$	68,194	$	525,018
14	State Income - Current	$	140,018	$	17,545	$	157,563
15	Deferred Fed Income	$	338,593	$	50,873	$	389,466
16	Deferred State Income	$	-	$	-	$	-
17	Investment Tax Credit	$	(17,158)	$	(4,194)	$	(21,352)
18	Total Operating Expenses	$	16,096,347	$	3,291,561	$	19,387,908
19	Net Operating Income	$	3,530,204	$	552,376	$	4,082,580